# THE ISSUE OF CAPITAL ACCOUNT CONVERTIBILITY – A POST CURRENCY CRISIS PERSPECTIVE

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**ABSTRACT**

The process of globalization has gathered momentum mainly due to the rapid increase in cross-border capital flows stimulated by trade liberalization and the rapid diffusion of information technology. The International Monetary Fund spearheaded the issue of freer capital mobility or capital account convertibility in order to spread the benefits of globalization to developing economies. However, a spate of currency crises and resulting in sudden capital flow reversals plunged countries that had achieved miracle growth rates with open capital accounts into economic turmoil. This paper reviews the first-best case for free cross-border flow of capital or capital account liberalization and the second-best case for capital controls in world riddled with domestic distortions. These distortions are identified in terms of asymmetric information that are intrinsic to capital or financial market transactions and non-information market failures that occur due to structural weaknesses in developing countries. The rationale for capital controls, the pre-conditions and sequencing of their removal in order to achieve sustainable capital account convertibility are reviewed. A typology of currency crises that have occurred recently and their proximate causes are identified. In particular it is shown that the Asian currency crisis was precipitated by a massive influx of unhedged short-term capital denominated in foreign currency to countries with fragile financial sectors and weak corporate governance. The paper distils lessons from the recent financial crises and reviews the three-pronged case for the reform of international financial architecture to mitigate the frequency of crises and the virulence of crisis contagion due to sudden capital flow reversals.

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|---|---|
| JEL | F31, F32 |
| KEYWORDS | Globalization. Capital Account Convertibility. Currency Crises. Asymmetric Information. Domestic Distortions. Prudential regulation. International Financial Architecture. |

# 1. INTRODUCTION

The Articles of Agreement of the International Monetary Fund (IMF) establishing the Bretton Woods System (BWS), a fixed exchange rate regime, in 1944 guaranteed foreign exchange for the conduct of free trade in goods and services or current account convertibility (Article VIII). However, it permitted IMF member countries to impose capital controls to achieve balance of payments and internal stabilization objectives (Article VI). The rapid globalization or the integration of economies of the world through the symbiotic processes of : trade liberalization or freer cross-border trade in commodities, communication via new high-speed telecommunication and information technologies, and through financial integration or freer cross-border trade in financial assets has created pressures to remove restrictions on international capital mobility. The IMF has spearhead the move to amend the BWS articles "to make promotion of capital account liberalization a specific purpose of the Fund and give the Fund appropriate jurisdiction over capital movements" (Interim Committee of the IMF, 28th April, 1987). However, in mid-July 1987 a sudden reversal of capital inflows reduced overnight the East Asian economies that had been growing at miracle growth rates to recession economies. This has dented somewhat the enthusiasm of the Fund to promote rapid capital account convertibility among developing countries (DCs). In this paper I shall revisit the issue of capital account convertibility highlighting the lessons learnt from the aftermath of the recent financial crises, especially the Asian currency crisis.

The process of globalization has witnessed a surge of capital flows to the emergent market developing countries. The total capital flows increased from an annual average of US$ 30.5bn in 1977-82 to a peak of US$240.8 bn in 1996. The composition of the capital flows also changed , banking lending which dominated capital flows was replaced by dominant flows of net foreign direct investment and portfolio capital flows. Furthermore the regional distribution of capital flows shows that in the mid-1990s before the Asian crisis the Asian region emerged as the main magnet for global capital flows (See Table 1).

These capital inflows have fuelled the miracle growth rates of the East Asian economies. Some of these emergent economies were converging or catching-up with the per capita income levels of the ACs as predicted by the neoclassical growth theory (Solow, 1953) but on the other hand low-income countries were diverging or lagging behind. The process of financial globalization has also increased the frequency of financial crises and the speeded up

***Table 1***. Anatomy of Capital Flows to Emerging Markets ( Annual averages, $US billion)

| **Capital Flow** | **1977-82** | **1983-89** | **1990-94** | **1995** | **1996** | **1997** |
|---|---|---|---|---|---|---|
| Total ($US billion) | 30.5 | 8.8 | 120.8 | 192.0 | 240.8 | 173.7 |
| **Composition of Capital Flows** | | | | | | |
| Net foreign direct | 11.2 | 13.3 | 46.2 | 96.0 | 114.9 | 138.2 |
| Net portfolio | -10.5 | 6.5 | 61.1 | 23.5 | 49.7 | 42.9 |
| Other ( bank lending) | 29.8 | -11.0 | 13.5 | 72.5 | 76.2 | -7.3 |
| **Regional Distribution of Capital Flows** | | | | | | |
| Asia | 15.8 | 16.7 | 40.1 | 95.8 | 110.4 | 13.9 |
| West | 26.3 | -16.6 | 40.8 | 35.7 | 80.5 | 91.1 |
| Other | -11.6 | 8.7 | 39.9 | 60.5 | 50.0 | 68.8 |

*Source*: :IMF, 1995; 1998.

crisis contagion or the spillover of its adverse effects to other countries in the region. Regional crisis contagion poses a threat to the systemic stability of the world financial system. Therefore, some have argued that the process of financial globalization should be reversed : " .. we will have to turn the clock at least part of the way back: to limit capital flows to countries that are unsuitable for either currency unions or free floating " (Krugman, 1999: 74). The same sentiments were echoed earlier when advocating the ' throwing sand on the wheels of international finance' or the imposition of transactions tax to limit short-term capital inflows and outflows (Tobin, 1978). This type of " simple one parameter tax would automatically penalize short-horizon round trips, while negligibly affecting incentives for commodity trade and long-term capital investments" (Tobin, 1996:xi). Furthermore, it is contended that such a tax would reduce exchange rate volatility by favouring Fundamentalists rather than the short-term extrapolative speculative activities of the Chartists (Frankel, 1996). DCs that open capital accounts will have to manage short-term capital inflows which have a tendency to reverse rapidly generating severe economic disruption. Thus while financial globalization has increased the pressures for opening up capital accounts, the recent financial crises have brought home the lesson that capital account liberalisation should be sequenced by other structural reforms in the domestic economy and also by reforms in the international financial architecture so as to reduce the frequency of financial crises and the virulence of crises contagion (Fischer, 1999).

The collapse of BWS in 1971 and the surge of short-term portfolio capital flows to developing countries (DCs) particularly in the 1990s, where capital flows trebled from $50 billion to $150 billion in a short-span of five years up to 1996 resulted in benefits and also created challenges for DCs. The rapid capital inflows resulted in the miracle growth rates of the high performance Asian economies (HPAEs) (World Bank, 1993). But at the same the currency crises such as the ERM crisis (1992) , the Mexico crisis (1994) and the Asian crisis (1997) revealed that capital inflows can dramatically reverse plunging miracle growth economies into recession economies overnight. The increasing volatility of capital flows and the virulence of crises and contagion effects due to sudden capital flow reversals has revived the debate on the need to control cross-border capital flows to DCs and reduce their disruptive effects and rapid contagion.

The paper examines the phenomenon of increasing cross-border capital flows and analyses the case for and against capital account convertibility.

The paper is organized as follows: Section II reviews the pros and cons of capital account convertibility by reviewing the theoretical arguments for the first-best case for capital account liberalization and comparing it with the second-best case for capital controls. The issue of sequencing and speed of capital account liberalization and the pre-conditions that have to be met to achieve sustainable capital account convertibility have been reviewed here. Section III provides a typology of currency crises that have occurred in the 1990s in terms of generation models. This typology will identify the proximate causes that have triggered the various generations of currency crises unleashing regional contagion and posing systemic threats to the stability of the global financial system. Section IV focuses on links between the financial and corporate sectors that caused the Asian financial crisis and underscores the need for setting up sound prudential regulation frameworks to overcome financial sector fragility. Section V discusses the need for more appropriate IMF policies for responding to financial crises in the context of globalization. Section VI discusses the issues relating to the reform of the global financial architecture to address issues related to capital flow reversals and resulting crises. Section VII concludes the paper presenting some of the lessons that would be instructive for the effective implementation of capital account convertibility.

## 2. ISSUES RELATING TO CAPITAL ACCOUNT CONVERTIBILITY

In a domestic distortion free first-best world free capital mobility or Capital Account Convertibility (KAC) like free trade would lead to the efficient allocation of resources and would be welfare maximizing. Some trade theorists contend that the theorems on the gains of free trade in commodities are also valid for the inter-temporal trade in financial assets ( Obstfeld and Rogoff, 1996). But others argue that information asymmetries and other distortions undermine the validity of gains from trade theorems in relation to trade in financial assets or capital mobility because they create welfare reducing moral hazard and herding behaviour (Bhagwati, 1998; Cooper, 1998).

Nonetheless, on a theoretical plane several arguments can be tendered in favour capital account convertibility or free cross-border capital mobility:

1. Free capital mobility or KAC will lead to allocative efficiency that would in turn maximise welfare of the asset trading nations in a manner analogous to free trade is best proposition amongst nations that free trade in goods and services. 2. KAC will also facilitate the access to the global pool of savings by savings constrained DCs. Thus bridging the saving-investment or the resource gap and contributing to increased investment and growth. 3. KAC promotes risk spreading and maximises the risk adjusted returns by the international diversification of asset portfolios. 4. KAC allows inter-temporal consumption smoothing in the context of the business cycle. 5. KAC exposes the economy to the discipline of the international markets by censoring imprudent policies by rapid capital inflow reversals. Relevant surveys of the first-best case for KAC is found in the papers by Dooley ( 1996) and Fischer (1998).

The real world cross-border trade in financial assets is riddled with market failure or domestic distortions. In such a second-best world free capital mobility or KAC can reduce welfare due to the effects of domestic distortions. These distortions could be classified broadly into distortions due to information asymmetries and non-information factors. First information asymmetries and thereafter non-information distortions are reviewed.

The unequal access to information or information asymmetry create several distortions and manifest in capital account transactions. These distortions are: 1. Adverse selection because borrowers have more information about the viability of a project than lenders and this leads lenders to select inferior rather than projects resulting in sub-optimal investment decisions. 2. Moral hazard problems where investors engage in risky behaviour and pass on the cost of failure to third parties such as the tax-payer. 3. Herding or panic behaviour as some investors ignore fundamentals and blindly follow market leaders on the premise that they have superior information. Although asymmetric information is an intrinsic characteristic of financial transactions (Eichengreen et al., 1999). Nonetheless the adverse welfare effects of these information asymmetries can be mitigated by designing institutional mechanisms that require the implementing of prudential supervision, transparency in decision--making , best practice accounting and good corporate governance of intermediaries engaged in financial transactions.

The non-information distortions that would caution against KAC in a second-best world could be enumerated as : 1. Fiscal distortions such as high taxes that would result in capital flight from the domestic economy in search of higher returns abroad. KAC could prevent such capital flight. 2. Legal distortions due to the absence of well defined property rights, again encouraging capital flight in search of better overseas pastures. 3. Trade distortions where free capital mobility may encourage the adoption of inappropriate capital intensive techniques in labour abundant DC. 4. The provision of a breather to implement structural adjustments leading to the reduction of distortions. 5. In the context of multiple equilibria KAC could also shown to be a first-best response (Obstfeld, 1996). These second-best arguments for capital account controls due to non-information distortions are discussed further in Dooley (1996).

The pros and cons of KAC points out that there are benefits and costs from liberalizing cross-border capital flows. At the practical policy level the issue of KAC rests on establishing pre-conditions that will maximize net benefits from implementing full convertibility and these require: 1. The establishment of a sound financial system. 2. The pursuit sound macroeconomic policies. KAC under a fragile financial system can lead to over-borrowing and build up short-term debt in terms of unhedged foreign currency liabilities. It can also result in the channelling of these borrowings to risky projects when the financial system lacks prudential supervision and is plagued by connected lending or crony capitalism. The pursuit of imprudent macroeconomic policies can lead to the provision of implicit guarantees under a fixed exchange rate regime which can lead to a lending boom and investment in risky projects. This would also render the economy highly vulnerable to exogenous shocks such as devaluation. A devaluation could erode its creditworthiness or rating due to the increase cost of its external liabilities denominated in local currency. The recent currency crises will that will be discussed next will reveal that KAC in the absence of the pre-conditions provided a fertile ground for breeding of a financial crisis.

At the practical policy level when implementing KAC issues of sequencing and speed of liberalization have to be addressed (Hanson, 1995;Fischer, 1998). It has been argued that because asset markets react more speedily to liberalization than commodity markets if KAC preceded current account convertibility (CAC) then inflow of capital would cause an appreciation of the real exchange rate undermine the trade liberalization of CAC process (McKinnon, 1973). However, others contend that KAL would lead to inflow or resources that could facilitate adjustment in such manner that will neither be inflationary nor lead to the appreciation of the real exchange rate resulting in a loss of a country's international competitiveness (Krueger, 199).

In the contemporary globalised financial world countries that adopted open capital accounts or KAC such as the ACs or the OECD countries and East Asian economies experienced miracle growth rates, whilst countries in South Asia and other DCs that had capital controls stagnated. Capital inflows through transnational corporations (TNCs) transferred to DCs the magic package of scarce capital, technology, managerial skills, and other firm specific assets that were needed to ignite the process of rapid investment and growth. The Asian growth miracle is arguably attributable to the adoption of KAC by East Asian economies to finance and implement their export-led growth strategies. Whilst other DCs that adopted capital controls and inward looking import substituting industrialisation strategies stagnated. The main types of capital controls have been either exchange rate controls, dual exchange rates and taxes on short-term capital flows or non-interest bearing deposit requirements for short-term capital flows. These controls have been justified on the grounds of redressing : disequilibria in the balance of payments, the need to retain domestic savings, the need to prevent the erosion of the domestic tax-base and in order to avoid jeopardizing stabilisation and structural reform programs (Mathieson and Rojas-Suvarez, 1993).

The countries with open capital accounts also exposed them to risks of currency crises due to massive short-term capital flow reversals due sudden changes in market sentiments. The casino economy generated by the sudden capital flow reversals have been highly disruptive from both growth and social welfare standpoints. Nonetheless, the countries with KAC experienced faster growth rates and achieved higher living standards than their counterparts that closed the doors to capital inflows and experienced relative stagnation. In this context the empirical studies that find that countries that adopted capital controls did not experience adverse macroeconomic performance (Rodrik, 1998) is some what puzzling and could be attributed to the use of simple dummy variables that do not capture the true nature of the intensity of capital controls (Edwards, 1999).

## 3. A CLASSIFICATION OF RECENT CURRENCY CRISES MODELS

A study of the anatomy of recent currency crises could shed light on the factors that precipitate speculative attacks causing the collapse of the currency peg and unleashing domestic financial turmoil and regional crisis contagion. The models of currency crises that occurred in the 1990s could be classified into three generation models following the classification of Flood and Garber (1998).

The first-generation model or canonical model of currency crises is based on the experience of the Latin American countries during the late 1970s. The currency crises were precipitated by expansionary fiscal policies that resulted in massive budget deficits. The monetisation of the deficits led to an exhaustion of foreign exchange reserves and precipitated a collapse of the exchange rate peg (Krugman, 1979). The first-generation model focuses on deteriorating macroeconomic fundamentals leading to a sudden reversals of capital and a collapse of the exchange rate peg. The macroeconomic fundamentals in East Asia were sound and these countries were managed prudently and therefore the first-generation models do not explain the occurrence of the East Asian financial crisis.

The second-generation models abstract from the experience of Exchange Rate Mechanism (ERM) crisis (1992) and the 'tequila crisis' that originated in Mexico (1994). The collapse of the peg is linked to rational self-fulfilling expectations that result in multiple equilibria . Such multiple equilibria models are analogous to bank-run models where self-fulfilling expectations switch a good equilibrium (no bank run) into a bad equilibrium (bank-run) or vice-versa due to changes in market sentiment (Diamond and Dybvig, 1983). In these second-generation models the policymakers' compare the benefits of maintaining the peg against the costs of a devaluation and abandon the peg for short-run macroeconomic policy gains. Often self-fulfilling actions facilitate the switch from one to another equilibrium as explained in the self-fulfilling multiple equilibria models (Obstfeld, 1996). Nonetheless, these self-fulfilling expectations multiple equilibria models of speculative attacks fail to explain the events that underpin the Asian currency turmoil that occurred in mid-1997.

Third-generation models attempt to stylise the causal mechanics precipitating the Asian currency crisis that began with the collapse of the Thai baht in the mid- 1977. In the first version of the third-generation model, it is postulated that implicit government guarantees encouraged moral hazard behaviour by financial intermediaries who engaged in 'Panglossian over borrowings' in unhedged foreign currency. These borrowings were facilitated by connected lending due the operation of crony capitalist links between banks and industry. The investments were channeled into risky real estate and asset purchases fuelling an asset price bubble that was destined to burst and trigger a massive capital inflow reversal (Krugman, 1998a). The implicit government guarantees ensured that foreign lenders in case their lending went into projects that went to the wall. This moral hazard behaviour exhibited by international investors was tantamount to organised theft (Dooley, 1999).

In a second version of the third-generation model, capital inflows under implicit guarantees were channeled into risky projects in the absence of prudential regulation by the banking and financial system. A sudden liquidity crisis caused by an exogenous shock, triggers panic and herd behaviour among lenders as they scramble to recall their short-term loans by refusing rollover their debts. This converts a liquidity crisis into an insolvency crisis and results in sudden reversal of capital inflows precipitating a full blown financial crisis (Radlet and Sachs, 1998).

The exogenous shocks that converted a liquidity crisis to an insolvency crisis that led to collapse of the currency peg in the East Asian economy manifested in several forms such as : an appreciation of the US dollar to which the Asian currencies were pegged; the depreciation of the Yen and the recession in Japan; the entry of China to the world market as an export competitor; and the oversupply of electronic goods- leading to the erosion of competitiveness and loss of export volume and revenue by the Asian economies in the buildup to the crisis in 1997 (Corbett and Vines, 2000).

The Asian financial crisis was not the upshot of weakening of macroeconomic fundamentals due to policies that were inconsistent with currency peg as foreshadowed in the first-generation models; nor was the crisis the result of self-fulfilling expectations converting a no-run equilibrium to a run-equilibrium but rather it was due to speculative attacks on the currency peg brought about a sudden reversal of capital flows due to financial sector fragility as highlighted in the third generation models.

Financial and corporate sector weaknesses played a critical role in precipitating the Asian crisis in 1977. These weaknesses increased the vulnerability of financial institutions to exogenous shocks. The existence of information and non-information distortions contributed to the magnification of the adverse effects of these shocks leading to panic behaviour among foreign lenders. They withdrew their funds regardless of the state of the fundamentals and the massive capital flow reversals led to the regional contagion of the crisis and threatened the stability of the global financial system.

## 4. FINANCIAL RESTRUCTURING AND BETTER PRUDENTIAL SUPERVISION

The recent currency crises offer a number of lessons for policymakers committed to reduction of the frequency of occurrence of financial crises in order to mitigate the adverse effects of regional crisis contagion.

The need for the reform of both domestic financial institutions and corporate financial structures as well as the implementation of sound macroeconomic policies are imperatives that a country should implement if it is to benefit from capital account convertibility and resulting capital inflows. Structural reforms should include the phasing out of nonviable financial institutions, establishing procedures for recapitalising and reinforcing viable institutions. Besides, the corporate sector needs to be restructured by improving prudential regulation and supervision and enforcing market discipline (Lindgren et al., 1999). Capital account liberalization "without first strengthening the prudential framework are a recipe for disaster" (Goldstein, 1998:6).

The Asian financial crisis was precipitated by the weaknesses in the financial and corporate sectors. The formal and informal currency pegs, which led to unhedged borrowing fuelled the rapid credit expansion and led to asset price inflation. The inflated asset prices stimulated further capital inflows under weakly supervised non-bank financial intermediaries. The highly leveraged corporate sector and large unhedged short-term debt made these economies vulnerable to sudden changes in market sentiment or changes in interest rates. Besides weak accounting standards, poor loan valuation, and disclosure practices masked the growing vulnerabilities from policymakers. The structural reforms to avoid crises recurrence needs to address these deficiencies and also the deficiencies in assessing country risk on the part of the lenders. The Asian financial crisis has highlighted the links between financial sector fragility and macroeconomic stability. Highly leveraged corporate sectors with massive unhedged short-term corporate debt denominated in foreign currency exposed the economy to foreign currency risks, especially under pegged exchange rates. The need for prudential regulation to avoid these pitfalls have to be underscored as one of the important lessons from the recent crises.

## 5. CURRENCY RISK

In the Asian currency crisis the foreign investors had misperceived the magnitude of both political risk and exchange rate risk or the so called currency risk. Many a monetary authority in developing Asia aimed to safeguard their exchange rate from the ravages of currency risk by the steadfast pursuit of a fixed exchange rate regime. An excellent analysis of these issues can be found in recent papers on the subject (see Makin, 1999a , 199b). For decades preceding the crisis the Central banks of the five Asian countries had provided domestic borrowers and foreign portfolio investors a modicum of exchange rate stability and certainty through the commitment to an exchange rate pegged to the US dollar. This resulted in interest rate differentials dictating the capital flows and foreign borrowings were unhedged were exposed to large currency depreciations. Government ownership of many Asian banks also signalled implicit government guarantees against default. This encouraged foreign lenders to understate the default risk, thus creating a moral hazard problem of too much borrowing and lending. From the foreign lending side there was another moral hazard effect that and from the expectation that the IMF might bailout creditors in the event of a collapse. The IMF bailouts encourage excessive international borrowing and lending activity and re-enforce the problem of moral hazard because the default risk associated with such an activity may be underestimated by the IMF. Hence the IMF bailout assistance affectively subsidizes those foreign lenders with long-term loans who are unable to liquidate their assets quickly and would otherwise have lose funds through careful default action. Moreover, loan default would teach financial institutions such as banks and mutual funds operating globally to assess the fundamentals of foreign economies more carefully. The need for proper risk evaluation by lenders.

## 6. IMF RESPONSE MECHANISMS FOR CRISES

The IMF under Article I is empowered to rescue member nations engulfed in a balance of payments crisis by providing a liquidity life-boat or emergency funding to restore confidence and arrest capital inflow reversals. In the case of the Asian currency crisis the IMF prescribed the orthodox medicine of expenditure reduction or fiscal contraction and expenditure switching or a devaluation to remedy the currency crisis. However, the core issue precipitating the currency crisis lay in the market perception that the Asian economies were in the grip of sovereign insolvency.

The IMF as lender of last resort during the Mexico crisis (1994) combined with the US Treasury and the G-10 countries to provide a massive bailout package to restore market confidence and reverse capital outflows. However, in the previous Latin American financial crises in the 1970s the partial defaults on sovereign debt and 'disorderly' debt workouts had resulted in deadlock and a lost decade of development for Latin America. In the Asian currency crisis, Thailand and South Korea opted to follow the Mexican solution and give blanket guarantees on repaying the foreign debts. However, Indonesia, which had massive unhedged corporate debts to foreign lenders defaulted. This has inflicted economic chaos and unprecedented social trauma in Indonesia. The Asian experience underscores the need for the establishment of bankruptcy procedures involving standstills on payments to lenders. The injection of liquidity and orderly debt workouts to avoid massive capital inflow reversals has to be addressed. There is a need for Chapter 11 , US Bankruptcy Code provision in the international arena.

This requires a revamping of the IMF's role of lender of last resort and collaboration with the World Bank to establish a new financial architecture that will address not only the debt default issues, but also issues related to the frequency and virulence of currency crisis contagion.

## 7. THE NEED FOR A RESTRUCTURED GLOBAL FINANCIAL ARCHITECTURE

The sudden and ferocious nature of the Asian financial crises revealed that the IMF had been napping on its Article IV surveillance and crisis monitoring functions. The IMF is now busily engaged in attempts to close the stable door after the steed has bolted. Nonetheless, the initiatives taken by the IMF now will help to mitigate the virulence of inevitable future crises in world of increasing capital mobility.

Among the attempts to restructure the global financial architecture strengthening the effectiveness of the lender of last resort (LOLR) function is a keystone in the architecture. To this end the IMF has introduced the Supplementary Reserve Facility (SRF) which requires sound macroeconomic policies, implementation of best practice surveillance standards. Furthermore, a Contingent Credit Line (CCL) has been established to provide quick relief to countries afflicted by crisis contagion.

On a broader front the effectiveness of the LOLR function will depend on the removing the major weaknesses of the present financial architecture in relation to surveillance, prudential regulation and transparency, and standards and best practice accounting. Furthermore, the establishment of bankruptcy procedures in the case of sovereign default to avoid debt workout deadlocks is imperative as cross-border capital flows are increasingly private rather than public. The involvement of the private sector in debt restructuring and crisis resolution and in the implementation of good corporate governance would contribute to the minimisation of moral hazard due to speculative risk taking.

The IMF by providing blanket guarantees to honour sovereign bailouts may fulfill its role as LOLR at the expense of the tax-payers of the crisis economy. It is imperative that the moral hazard resulting from giving blanket bailout guarantees be countermanded by appropriate institutional reforms, so that the IMF will preserve its integrity as a LOLR rather than international debt collector for the international creditors of DCs.

## 8. CONCLUDING PERSPECTIVES AND LESSONS FOR CAPITAL ACCOUNTING CONVERTIBILITY

The above review of the recent Asian currency crises proffers several lessons that would be useful for the effective implementation of capital account convertibility. First, the fragile domestic financial system should reformed and placed on a sound basis, so that it has the capacity to prudentially regulate the large inflow of capital under an open capital account is strengthened. Second, capital account convertibility should be preceded by establishing sound macroeconomic fundamentals by pursuing policies of fiscal sustainability and price stability. For example, in the presence of large fiscal deficits open capital accounts presents a window to financial intermediaries to engage in external borrowing that would lead to the accumulation of foreign debts. Third, under exchange rate flexibility that is inevitable under a liberalized capital account monetary policy design needs to replace gap left by abandoning the nominal exchange rate anchor. In this connection inflation targeting could play a role. It could provide the policy credibility and obviate the need for large interest rate hikes and exchange rate devaluations which could turn a good equilibrium into a bad equilibrium and convert a crisis into collapse as was observed in the Asian crisis. Fourth, the IMF should lift its game on surveillance under Article IV and establish better modelling of crisis vulnerability and early warning systems of impeding crises. The IMF in its General and Special Data Dissemination Standards (GDSS and SDSS) is addressing the issue. Furthermore, other institutions such as the International Bank for Settlement (BIS) under the Basle Core Principles (BCP) review the capital adequacy requirements which bias capital flows against long-term maturity flows and in favour of short-term maturity flows. Fifth, the private sector should be involved in debt restructuring, corporate governance and risk assessments so as to minimise moral hazard of risky lending under implicit IMF bailout guarantees. Sixth, the Fund should coordinate its micro functions of surveillance and prudential supervision with the macro institution building functions of the Bank to avoid potential conflicts. Because of the prospect of massive capital inflows after capital account convertibility the gap between the rich and poor in the economy could widen unleashing political tensions therefore the issue of equity should be addressed. In this regard the IMF Poverty Reduction Growth Facility (PRGF) is a step in the right direction.

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